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STATE PASS USTR FOR KDUCKWORTH
STATE PASS EXIMBANK
STATE PASS OPIC FOR DMORONSE, NRIVERA, CMERVENNE
DEPT OF TREASURY FOR JHOEK
USDOC FOR 4332/ITA/MAC/WH/OLAC

SIPDIS
SENSITIVE

E.O. 12958: N/A
TAGS: ECON ELAB EIND EAGR ENRG KTDD EINV BR
SUBJECT: SOARING FOOD PRICES WOLDWIDE AND FOOD INFLATION IN BRAZIL

SENSITIVE BUT UNCLASSIFIED--PLEASE TREAT ACCORDINGLY

REF: Sao Paulo 207

¶1. (SBU) SUMMARY: Brazil has suffered less from skyrocketing world food prices than other emerging markets. As a net global food supplier, Brazil's agricultural exports earnings are climbing. However, rising global inflation - particularly higher oil prices, which affect both the cost of fertilizers and the costs of transportation - has spilled over into domestic prices, driving up inflation expectations, and forcing the Central Bank to raise interest rates. This quick, anti-inflationary monetary policy and the net benefits that rising food prices have on Brazil's balance of payments mean that Brazil remains well-positioned to address near-term food inflation pressures. In the medium term, Brazil does face some risk from food inflation via a potential decrease in long-term global demand for biofuels. To the extent that rising food inflation affects global perceptions regarding biofuels, Brazil's longer-term economic outlook could be affected given its significant investments to develop and promote a global biofuels industry. END SUMMARY.

RISING FOOD INFLATION IN BRAZIL; THE ECONOMIC RISKS
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¶2. (SBU) Rising food inflation poses four near-term economic risks for Brazil: First and most immediately, it will intensify headline inflation and pressures on central banks to tighten monetary policies, especially those with inflation targets, such as Brazil. A second risk is a potential decline in fiscal discipline as governments expand subsidies or price controls in response to food inflation. A third risk is balance of payments shocks for countries that are net food importers. A final risk is an increase in trade protection. Argentina, for example, has raised tariffs on food exports, a measure that has resulted in protests by farmers that could reduce local production and raise food prices there further. Other countries have banned food exports, a move also likely to restrict supplies and further pressure food prices. Brazil has joined this group by stopping some rice exports in order to supply the domestic market with this important staple.

¶3. (SBU) In the near-term, food inflation (which is significantly

tied to rising petroleum prices) has been a primary cause for higher headline inflation. Over the past year, food prices have risen by 12 percent in Brazil compared with a three percent increase in non-food prices and a 4.7 percent increase in the Consumer Price Index (CPI). The price of soybeans showed the steepest increase, (126 percent) followed by meat, (23 percent) and bread (13 percent). Food inflation will remain much higher than non-food inflation for the next year. In the past year, the CPI rose 1.25 percent, while inflation expectations rose by more than 0.5 percentage point to 4.8 percent over the past six months. Concerned about rising inflation, the Brazilian Central Bank (BCB) recently began a tightening cycle and raised the benchmark Selic rate by 0.5 percentage points on April 16 to 11.75 percent. Market forecasts for credit expansion and investment growth this year have been reduced accordingly. (Comment: S&P's move to upgrade Brazil to investment grade on April 30 may revise expectations of investment growth upward and will be reported septel. End Comment.) According to Luiz Fernando Figueiredo of Maua Investments, the investment community expects two more interest rate hikes of 0.5 percentage points each between now and July. There is little expectation that the current tightening cycle will result in rates rising more than 1.5 to two percentage points.

¶4. (SBU) While the medium-term impact from food inflation should be limited, there remain some areas of concern. Biofuels have been increasingly blamed for the rising scarcity of global food supplies and the resulting rise in food prices. As a result, Brazil and the U.S., the world's two largest ethanol producers, have been accused of exacerbating food inflation and pushing up to 100 million people closer to poverty, according to a World Bank estimate. A prolonged cycle of food inflation and concerns about the rising social costs



of biofuels could cause a permanent downward shift in some countries' demand for biofuels, especially in Europe. However, the vast majority of ethanol is used for domestic consumption and that demand is growing rapidly (reftel). Further, the largest share of ethanol exports go directly or indirectly to the United States, where demand for ethanol is likely to increase and which does not seem to be affected by the outcry over sustainability. Overall, the impact on Brazilian exports should be small, but there remains the potential for the food versus fuel debate to hurt Brazilian exports, and undermine Brazilian economic and political investments in internationalizing the sector.

## BRAZIL SET TO WEATHER THE STORM?

¶5. (SBU) Compared to many other countries, Brazil appears well-positioned to withstand near-term food price pressures. This conclusion is based on the following factors: (1) Brazil's share of food consumption in household budgets is lower than in many other countries. Food represents 21 percent of average household consumption in Brazil compared to higher shares in many other countries (over 50 percent in much of Africa and 70 percent in the world's poorest countries). This more limited role will help to contain broader inflation spillovers and reduce Brazil's relative need for monetary tightening. (2) The BCB is acting preemptively against rising inflation. The decision last month to raise rates by 0.5 percentage points was double the expected hike, and was the first of several hikes expected this year. Recent Central Bank statements have been hawkish. While tighter policy will slow near-term growth, it should decrease the risk that inflation could spiral upwards as well as help stabilize monetary policy over the medium-term. In contrast, central banks in many other countries have reacted more slowly. Several governments have responded by tightening price controls - a measure that will repress inflation in the short-run but risks a price spike once controls are lifted. (3) Brazil's fiscal policy is more firmly anchored than many other countries. Although Brazil does not have an explicit fiscal target, it maintains an informal primary surplus target of 3.8 percent of GDP that is closely watched by markets. With GOB expenditures equivalent to roughly 40 percent of GDP, Brazil has little fiscal space in which to expand public spending. (4) Brazil is a net food exporter and perhaps most importantly, Brazil's trade account benefits directly from higher food prices through improved

terms-of-trade. Food represents one-third of Brazilian exports and a large share of its overall trade surplus. Major food exports include beef, chicken, soy, rice, sugar, orange juice, and coffee, all goods whose prices have risen. Brazil's situation contrasts with most other developing countries, 70 percent of which are net food importers and whose external financing needs are increasing as a result of rising food prices.

¶6. (SBU) Nonetheless, Brazil does face some near-term challenges. For example, with 31 percent of Brazil's population below the national poverty line and one-third of its population suffering from "food insecurity", ever-present pressures exist to expand Brazil's social safety net. Rising food prices could increase demands to raise public wages - an issue on which President Lula's government has a weak track record. Faster wage growth could likely be paid for only through reductions in spending on the government's growth acceleration plan (PAC), slowing Brazil's future growth potential.

COMMENT
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¶7. (SBU) Brazil is well-positioned to cope with the near-term and mid-term effects of rising food inflation. Monetary policy has responded quickly to rising prices, fiscal policy is well-anchored, and Brazil's current account balance benefits strongly from higher food prices. There is a potential risk that food inflation may have a significant negative spillover into long-term global demand for Brazilian biofuels exports. To the extent food inflation harms perceptions about the costs and benefits of biofuels, future demand for biofuels exports could wind up being somewhat flatter than is currently envisioned. While not catastrophic for Brazil, this



development is likely to hinder Brazil's ethanol industry from realizing the full growth, scale, and global stature to which Brazil aspires. END COMMENT.

¶8. (U) This cable was written in conjunction with the Treasury Attache and was coordinated and cleared by the Embassy in Brasilia.

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